

ESG Investing: Theory & Practice

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A Short History of ESG Investing

- **Bringing ethical considerations into investments decisions is not something new**
 - The Bible, Jewish Law & Islamic tradition have addressed the issue
- **Concept took off in the 60s & 70s**
 - US university endowments boycott to South Africa
- **In 2006, the United Nations (Kofi Annan), introduced the Principles of Responsible Investment (PRI)**
 - Six general guidelines aimed at incorporating E(nvironmental), S(ocial), and G(overnance) factors into investment-decision processes
- **Situation today**
 - 7,000 corporate entities in 135 countries have become signatories to these principles
 - ESG assets are estimated at \$ 35 trillion
 - There is a great deal of confusion about ESG implementation

The Six Principles

- 1] We will incorporate ESG issues into investment analysis and decision-making processes
- 2] We will be active owners and incorporate ESG issues into our ownership policies and practices
- 3] We will seek appropriate disclosure on ESG issues by the entities in which we invest
- 4] We will promote acceptance and implementation of the Principles within the investment industry
- 5] We will work together to enhance our effectiveness in implementing the Principles
- 6] We will each report on our activities and progress towards implementing the Principles

Major Challenges

- ❖ No clear definition of what E, S and G means (in fact, there are contradictory competing definitions)
- ❖ Lack of agreement regarding the elements to consider when assessing E, S and G plus: (i) how to “measure” these elements; and (ii) weighting factors (how to “combine” them)
- ❖ Proliferation of ESG experts with dubious credentials
- ❖ Many ESG-related studies are done by parties with obvious conflict of interest and/or containing major methodological flaws
- ❖ Greenwashing (danger of) & great deal of hypocrisy
- ❖ ESG ratings do not offer much help (lack validity, reliability & agreement)

Our Study of ESG Ratings

- ❖ **We considered all the companies included in the S&P 500 index as of January 2022 (501 in total)**
 - **MSCI (476)**
 - Seven categories: AAA, AA, A, BBB, BB and CCC
 - **S&P (501)**
 - From 0 to 100
 - **ISS (492)**
 - From 1 to 10
 - **Sustainalytics (489)**
 - From 0 to 45 (more or less)

Inter-Rater Agreement: Comparisons of Ratings

RA 1	RA 2	$T_{TW}(0)$	$T_{TW}(1)$	$T_{TW}(\text{Pass/Fail})$
MSCI	ISS	-0.001	0.096	0.251
MSCI	S&P	0.093	0.372	0.529
MSCI	S-A	0.075	0.378	0.383
S&P	ISS	0.044	0.087	0.236
S&P	S-A	0.088	0.272	0.362
S-A	ISS	0.024	0.034	0.157

Average **0.054** **0.206** **0.320**



{1, 2, 3, 4} OR {5, 6, 7}
Pass **Fail**

1.0

METEREOLOGY (0.91, 0.75)

CREDIT RISK (0.90, 0.70)

**CLINICAL
PSYCHOLOGY (0.70, 0.49)**

WINE (0.50, 0.34)

0.4

ESG RATINGS (0.18, 0.05)

↑
reliability

↑
agreement

0.0

Semantical Interpretation of Different Reliability/ Agreement Levels (*)

Magnitude of Coefficient

Strength of Reliability/ Agreement (Interpretation)

< 0.40
0.40 – 0.59
0.60 – 0.74
0.74 – 1.00

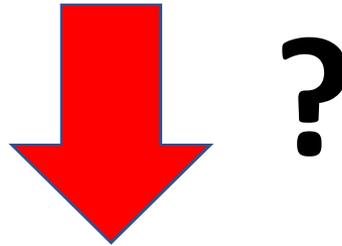
Poor
Fair
Good
Excellent

(*) based on Cicchetti and Sparrow (1981)

Conclusions

- ❖ Notwithstanding the previously-identified challenges the idea of incorporating an ethical dimension into any investment process has merit

CHALLENGE



- How do we go about that?
- How do we build an ESG-compliant portfolio?